

# ERM-ILA Model Solutions

## Spring 2013

### 1. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

### Learning Outcomes:

- (2c) Analyze and evaluate risk aggregation techniques, including use of correlation, integrated risk distributions and copulas.
- (2f) Analyze the importance of tails of distributions, tail correlations, and low frequency/high severity events.

### Sources:

ERM-101-12: Measurement and Modeling of Dependencies in Economic Capital  
Pages 22 (Section 5.6 Copulas) to 81

Financial Enterprise Risk Management, Sweeting, 2011 Chapter 10.4, Copulas  
(Pages 195 to 219)

### Commentary on Question:

*The focus of this question was the concept of copulas as well as calculation of lower tail dependence and upper tail dependence using a copula formula. Successful candidates were expected to demonstrate their knowledge of the concept and formulas. As the tail dependence formulas use the concept of limits, some candidates lost partial points due to inability to perform the required calculus.*

### Solution:

- (a) Demonstrate that each marginal risk factor distribution is uniform on  $[0,1]$  using the Clayton copula.

### Commentary on Question:

*This question required the candidates to recall that uniform means  $C(x, 1) = x$  and  $C(1, y) = y$ , from the reading source.*

### Response:

$$C(x, 1) = (x^{-\theta} + 1^{-\theta} - 1)^{-1/\theta} = (x^{-\theta} + 1 - 1)^{-1/\theta} = (x^{-\theta})^{-1/\theta} = x$$
$$C(1, y) = (1^{-\theta} + y^{-\theta} - 1)^{-1/\theta} = (1 + y^{-\theta} - 1)^{-1/\theta} = (y^{-\theta})^{-1/\theta} = y$$

## 1. Continued

Therefore, each marginal risk factor distribution is uniform on  $[0,1]$  using the Clayton copula.

- (b) The chief actuary at Joint Life is unfamiliar with copulas and prefers to use the variance-covariance approach when reflecting dependency between random variables. He recommends increasing the correlation factor in order to reflect the upper tail dependence that exists between  $X_1$  and  $X_2$ .

Provide advantages and disadvantages of the chief actuary's approach.

### **Commentary on Question:**

*Many candidates lost points in part (b) as they only answered from the general list of advantages and disadvantages of copulas relative to the variance-covariance approach, and didn't evaluate the chief actuary's approach of increasing the correlation factor in the context given.*

### **Response:**

Advantages of the chief actuary's approach:

- Current level of comfort with this approach
- Copulas are difficult to parameterize and more difficult to explain. Variance-covariance is simple and easy to communicate.
- Increasing the correlation factor will result in increased likelihood being assigned to extreme right tailed events. While this approach will not achieve the correct correlation across the entire distribution, Joint Life Co. is likely to be only concerned with the right tail.

Disadvantages of the chief actuary's approach:

- While increasing the correlation factor will result in increased likelihood being assigned to extreme right tailed events, it will also increase the likelihood being assigned to the rest of the distribution.
- The variance-covariance approach will not capture other than linear dependence structures, whereas the copula approach will enable Joint Life Co. to capture a more diverse set of correlations between its risk factors.
- Copula use is consistent with a typical actuarial and financial risk modeling process whereby marginal risk distributions for each risk are first determined and then one considers separately the aggregation process.

- (c) Demonstrate that use of the Clayton copula results in an increasing level of lower tail dependence as the parameter  $\theta$  increases.

# 1. Continued

## Commentary on Question:

Generally candidates did well in part (c). Some candidates lost partial points due to failure in calculating the limit. Candidates received partial points if they showed sample numerical results rather than providing a full demonstration.

## Response:

Lower Tail Dependence:

$$\lim_{x \rightarrow 0} C(x, x) / x = \lim_{x \rightarrow 0} (x^{-\theta} + x^{-\theta} - 1)^{-1/\theta} / x = \lim_{x \rightarrow 0} (2x^{-\theta} - 1)^{-1/\theta} / x = \lim_{x \rightarrow 0} (2 - x^{\theta})^{-1/\theta} \\ = (2)^{-1/\theta}$$

As  $\theta$  increases,  $1/\theta$  decreases,  $-1/\theta$  increases and  $(2)^{-1/\theta}$  increases. Hence, lower tail dependence increases for increasing values of  $\theta$ .

- (d) One of your colleagues has developed a new copula, the FGM copula. You are given:

$$\text{FGM Copula: } C(x, y) = xy[1 + \theta(1-x)(1-y)]$$

Determine whether the use of the FGM copula is appropriate when modeling the joint distribution for  $X_1$  and  $X_2$ .

## Commentary on Question:

Many candidates had difficulties with the formula of upper tail dependence and calculation of the limit. However, if candidates understood the concept, but made errors in the calculation, they still received partial points.

Some candidates only tested for upper tail dependence as that is enough to show the FGM copula is not appropriate for the intended purpose.

## Response:

Upper Tail Dependence:

$$\lim_{x \rightarrow 1} [1 - 2x + C(x, x)] / (1 - x) = \lim_{x \rightarrow 1} [1 - 2x + x^2 + x^2\theta(1-x)^2] / (1 - x) \\ = \lim_{x \rightarrow 1} [1 - 2x + x^2] / (1 - x) = \lim_{x \rightarrow 1} (1 - x)^2 / (1 - x) = \lim_{x \rightarrow 1} (1 - x) = 0$$

There is no upper tail dependence.

## 1. Continued

Lower Tail Dependence:

$$\lim_{x \rightarrow 0} C(x, x) / x = \lim_{x \rightarrow 0} x^2 [1 + \theta(1 - x)^2] (1 / x) = \lim_{x \rightarrow 0} x [1 + \theta(1 - x)^2] = 0$$

There is no lower tail dependence.

The use of the FGM copula is not appropriate as it has neither upper nor lower tail dependence.

## 2. Learning Objectives:

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.
3. The candidate will understand how the risks faced by an entity can be quantified and the use of metrics to measure risk.

### Learning Outcomes:

- (1c) Identify and analyze risks faced by an entity, including but not limited to market risk, currency risk, credit risk, spread risk, liquidity risk, interest rate risk, equity risk, hazard/insurance risk, inflationary risk, environmental risk, pricing risk, product risk, operational risk.
- (2c) Analyze and evaluate risk aggregation techniques, including use of correlation, integrated risk distributions and copulas.
- (3e) Define and evaluate credit risk. Explain how to incorporate best practices in credit risk measurement, modeling and management.

### Sources:

Financial Enterprise Risk Management, Sweeting, 2011

- Chapter 7, Definitions of Risk
- Chapter 14, Quantifying Particular Risks

ERM-106-12: Economic Capital-Practical Considerations – Milliman

Value-at-Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion, 2007

- Chapter 18, Credit Risk Management (excluding Appendices)

### Commentary on Question:

*The majority of candidates performed well on the first half of the question. The subsections were fairly straightforward and it allowed the candidates to demonstrate their understanding of credit risk, how to use the Merton model to calculate a default probability and how different parameters impact the default probability calculated by the Merton model.*

*The second half of the question required a much deeper level of understanding about the Merton model, including a theoretical question in part (d) and specific application questions with respect to sovereign debt in parts (e) and (f). It was clear from the responses that some candidates did not understand what sovereign debt was.*

## 2. Continued

*Sovereign debt refers to foreign government debt, and perhaps there was confusion over the use of the term “sovereign” in the exam. Our expectation had been that candidates would have had a basic understanding of sovereign debt at this stage of the exams. However, as this understanding was not evident and sovereign debt is only briefly mentioned in the ERM exam study material, the grading was adjusted to compensate for the lack of information on the subject matter.*

*When it came to applying the Merton model and Discriminant Analysis to sovereign credit risk modeling, there were only a few candidates who provided enough explanation and detail to show comprehension of how these methods and models work qualitatively.*

### **Solution:**

(a)

- (i) Define credit risk.
- (ii) Describe the four components that should be considered when modeling credit risk.

### **Commentary on Question:**

*Most candidates performed well on this question. Some candidates did not provide appropriate components in sub-part (ii), or they did not describe the components that they listed, but a majority of candidates received most of the points on this section of the question.*

### **Response:**

- (i) Risk of financial loss owing to a counterparty failure to perform its contractual obligations / make payment when payment is due.
- (ii)
  - 1. Probability of Default / Default risk
    - Likelihood of default by the counterparty
  - 2. Credit Exposure
    - Risk of fluctuations in the market value of the claim on the counterparty
    - At default, known as the exposure at default (EAD)
  - 3. Recovery Risk
    - Uncertainty about the fraction of the claim to be recovered after default
    - Known as  $(1 - LGD)$ ,  $LG D =$  loss given default
  - 4. Migration Risk
    - Adverse variations in transitions between credit ratings

## 2. Continued

- (b) Calculate Crow's probability of default using the Merton model.

**Commentary on Question:**

*Most candidates performed extremely well on this question and were able to apply the Merton model correctly in the given situation.*

*Some candidates flipped the Asset Value and Total Debt. Given that the Merton Model defines a company as being in default when the debt is greater than a company's assets, the candidate should have recognized the variable assignment to be incorrect when equating the variables that way. There were also some candidates who confused the asset value volatility and variance.*

**Response:**

Crow's Asset Value =  $X_0 = \$800,000,000$

Crow's Asset Value Growth Per Year =  $r_A = 8.4\%$

Crow's Asset Value Volatility Per Year =  $\sigma_A = 20\%$

Crow's Total Debt =  $B = \$500,000,000$

Crow's Debt Term =  $T = 1$  year

$$\begin{aligned} P(X_1 \leq 500) &= \Phi((\ln(500/800) - (0.084 - (0.2^2)/2) * 1) / (0.2 \sqrt{1})) \\ &= \Phi((-0.47 - 0.064) / (0.2)) \\ &= 1 - \Phi(2.67) \\ &= 0.0038 \end{aligned}$$

- (c) Explain how each of the following would impact CQC's assessment of the probability of default for the Crow bond.
- (i) Crow's asset book value decreases.
  - (ii) The risk free rate increases.
  - (iii) Crow's asset value volatility decreases.

**Commentary on Question:**

*Most candidates performed well on this part of the question. Partial credit was given to candidates who relied on more of a technical / numerical demonstration and full credit was assigned to candidates who could provide a more qualitative / theoretical explanation.*

## 2. Continued

*As the risk free rate was not given in the question nor linked to Crow's asset growth rate, sub-part (ii)'s answer could be based on an analysis of the Merton model or more general reasoning. Credit was given for any reasonable discussion of the impact of an increase in the risk free rate.*

### Response:

(i)

- This increases Crow's individual probability of default.
- Crow is closer to being insolvent because the Merton model defines insolvency when assets are insufficient to cover liabilities (assets fall below its debt).

(ii)

- This does not directly impact Crow's default probability.
- The Merton model uses the asset growth rate to calculate an asset's probability of default.
- Therefore, barring a change in the risk free rate and its impact on Crow's asset return, its default probability doesn't change.

(iii)

- This decreases Crow's likelihood of default
- The volatility of results and asset growth is now more stable than before.
- This makes it less likely there will be huge downswings in the firm's value resulting in insolvency as there is a lower probability of the assets going lower than liabilities.

- (d) Explain why the formulation of the Merton model above uses  $r_A$  whereas the standard option pricing formula using Black-Scholes uses the risk free rate.

### Commentary on Question:

*Some candidates struggled to provide an answer to this question and did little more than just restate the question. Others were more successful with relating the rates back to the purposes of the models. This was a higher-cognitive level question as there was not a direct response in the syllabus.*

### Response:

- Crow is interested in the probability of default in the real world, which the Merton model defines as the probability the value of the firm's assets  $X$ , at a fixed time  $T$  in the future,  $X_T$ , will be below the level of debt,  $B$ , at the same time  $T$ .



## 2. Continued

- The default probability and assets used are firm specific, thus the actual asset growth rate is needed for this determination.
  - Black-Scholes is used for risk-neutral option pricing where investors expect to earn the risk-free-rate.
- (e) Describe the Merton model and evaluate its use with respect to modeling sovereign credit risk.

### **Commentary on Question:**

*Some candidates struggled on this question due to the sovereign credit risk modeling component. Although candidates could describe the Merton model, most could not relate it well to sovereigns. There was not a lot on sovereign debt and credit risk in the syllabus, but it was expected that candidates would have general background knowledge on how sovereign debt would differ from a corporate bond. With an understanding of the Merton model, its strengths and weaknesses and a basic understanding of sovereign holdings, candidates should have been able to analyze how the Merton model would or would not work for sovereign debt holdings. The grading was adjusted to compensate for the evident lack of knowledge about sovereign debt.*

### **Response:**

#### Merton Model

- The Merton model is a structural model and the insolvency occurs when the value of the firm falls below the level of debt outstanding
- The value of the firm is assumed to follow a lognormal random walk process
- It is most appropriate for large borrowers with liquid, frequently traded equity stock since an accurate estimate for the volatility of corporate equity is needed

#### Model Adequacy for Sovereign Debt

- The Merton model is not appropriate for calculating the probability of default on the sovereign and government risks in CQC's portfolio based on a number of unresolved issues
  - 1) How to appropriately model the asset value (whatever it is) using a lognormal process
  - 2) How to incorporate foreign exchange rates into the calculation
- Sovereigns are not equity-based borrowers, making it difficult to assign a tangible asset value and volatility parameter utilizing the Merton model's principles

## 2. Continued

- It is difficult to determine what the insolvency level would be for a sovereign
  - 1) Nations may have more debt outstanding relative to their GDP levels and are not considered insolvent at that level
  - 2) Some nations may have mechanisms to avoid default that a corporation does not, such as raising taxes and printing money
- (f) Explain the discriminant analysis approach to modeling credit risk and describe how you might implement such an approach with respect to modeling sovereign credit risk.

### **Commentary on Question:**

*This question was not answered in a lot of detail by candidates and those candidates who performed better in (e) also tended to do better in this section. Most candidates were able to describe discriminant analysis, but did not explain in much detail how it could be used for sovereign debt credit risk modeling.*

### **Response:**

#### Discriminant Analysis

Discriminant analysis, as it pertains to credit modeling, is a quantitative approach that attempts to arrive at a credit score that represents the likelihood of insolvency for an entity.

- The most familiar credit modeling approach using this technique is Altman's Z-score.
- The Z-score is determined by using financial ratios
- The Z-score is calculated by using a linear equation, which is parameterized by these financial ratios

In order to implement this approach for sovereign/government bond credit risk modeling:

- The Z-score can be modified to use other types of ratios based on economic, financial and socio-political data that are specific to sovereign nations – for example, the ratio of the present value of debt payments and/or debt interest payments to GDP levels, exports, unemployment levels, type of government (democratic, dictatorship, communist, etc.), and so on
- Note that creating these modified ratios may be difficult due to a lack of information
- The ratios may have highly skewed distributions (developing nations vs. established), which violate the underlying assumption that the variables used are independent and normally distributed

### 3. Learning Objectives:

4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

#### Learning Outcomes:

- (4a) Evaluate the rationale for managing risk and demonstrate the selection of the appropriate risk retention level and hedging of risk.
- (4c) Demonstrate means for transferring risk to a third party, and estimate the costs and benefits of doing so.
- (4e) Demonstrate how derivatives, synthetic securities, and financial contracting may be used to reduce risk or to assign it to the party most able to bear it.
- (4k) Analyze methods of managing other risks (operational, strategic, legal and insurance) both pre-event and post-event.

#### Sources:

ERM 108-12: Tiller, Life, Health and Annuity Reinsurance, 3rd Edition, 2005 Ch. 5  
Advanced Methods of Reinsurance

ERM 108-12: Tiller, Life, Health and Annuity Reinsurance, 3rd Edition, 2005 Ch. 17  
Special Purpose Reinsurance Companies

Financial Enterprise Risk Management, Sweeting, 2011 Ch. 16 Responses to Risk

#### Commentary on Question:

*This question is intended to test the candidate's ability to perform a cost-benefit analysis for a specific situation and present results to senior management in a well-organized and articulated manner. The analysis should be concise and clearly attempt to identify the key terms in a manner which is comparable across the options being considered. The request for additional information from management should demonstrate the candidate's insight from a risk management perspective.*

#### Solution:

- (a) Management wants to evaluate the relative merits of the options listed above using a cost-benefit (including risks) analysis. Prepare a comparison of the three options considering at least five criteria that you consider key to making a decision.

#### Commentary on Question:

*Stronger candidates provided a complete analysis (i.e. identifying all of the key criteria which should be considered in evaluating this decision) as well as a clear and concise presentation of the alternatives being considered. The mere listing of criteria without a comparison of the alternatives being considered did not satisfy the requirements for this part.*

### 3. Continued

**Response:**

<b>Option No.</b>	<b>I - Stop Loss</b>	<b>II - Cat Bond</b>	<b>III - Swap</b>
<b>Annual Cost</b>	2.35M	2M	6.25M
<b>Max Coverage</b>	50M per annum	50M total	75M total
<b>Deductible (above expected claims)</b>	50M per annum	50M per annum	110M per annum
<b>Term</b>	Annual Renewable	5 Years	3 Years
<b>Counterparty Risk?</b>	Yes	No	Yes
<b>Basis Risk?</b>	No	No	Yes

For option II, the max coverage is \$50M for the entire 5 year period (as opposed to an annual limit).

For option III, the max coverage is \$75M for the entire 3 year period (as opposed to an annual limit).

- (b) Identify which of the three options is least favorable to Hamsik. Justify your response.

**Response:**

Option III - SWAP is the least favorable

- ⇒ Most expensive - \$6.25 M annual cost (and most expensive per unit of maximum benefit provided)
- ⇒ Largest Deductible -- covers mortality risk above 8.4% only
- ⇒ Lowest absolute amount of coverage
- ⇒ Introduces both counterparty and basis risks

- (c) You need more information in order to make a recommendation as to which option is most favorable to Hamsik.

Identify five key questions you would ask Hamsik senior management to enable a more informed recommendation.

### 3. Continued

#### **Commentary on Question:**

*This part asked for the **key** questions you would ask of senior management to get the information needed to make a decision. Therefore, the questions needed to reflect the candidate's understanding of how this decision fit into the broader objectives of Hamsik, specifically, ERM related objectives. Weaker candidates responded with very detail-oriented questions (such as counter-party credit standing, details on bond provisions or underwriting guidelines). While relevant, these were awarded fewer marks as they were not "key". For example, a number of candidates provided questions on better understanding expected mortality levels. This information was already provided in the question (i.e., both Hamsik and industry level expected mortality).*

*A variety of possible questions are provided below. Only five appropriate questions were needed to receive full credit.*

#### **Response:**

- What is Hamsik's objective in entering into this agreement?
  - ⇒ Does the company intend to manage or transfer catastrophe mortality risk?
  - ⇒ Does the company want to hedge this risk or immunize itself?
- What is Hamsik's mortality experience for this block of business; i.e., has it been volatile?
- What is Hamsik's annual budget for this program?
- What is Hamsik's risk appetite in general and for catastrophic mortality events specifically?
- How much capital does Hamsik have available to cover catastrophic mortality losses?
- How much does management appreciate the benefit of locked in coverage? Is management comfortable with the risk of renewing annual coverage at a potentially higher cost or are they willing to pay more for coverage extending over a number of years?

#### **4. Learning Objectives:**

1. The candidate will understand the types of risks faced by an entity and be able to identify and analyze these risks.
4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.
5. The candidate will understand the concept of economic capital, risk measures in economic capital assessment and techniques to allocate the cost of risks within business units.

#### **Learning Outcomes:**

- (1c) Identify and analyze risks faced by an entity, including but not limited to market risk, currency risk, credit risk, spread risk, liquidity risk, interest rate risk, equity risk, hazard/insurance risk, inflationary risk, environmental risk, pricing risk, product risk, operational risk.
- (4c) Demonstrate means for transferring risk to a third party, and estimate the costs and benefits of doing so.
- (4h) Define credit risk as related to derivatives, define credit risk as related to reinsurance ceded, define counterparty risk and demonstrate the use of comprehensive due diligence and aggregate counterparty exposure limits.
- (5a) Describe the concept of economic measures of value and demonstrate their uses in the risk management and corporate decision-making processes.
- (5b) Define the basic elements and explain the uses of economic capital.
- (5d) Apply risk measures and demonstrate how to use them in economic capital assessment. Contrast and understand regulatory, accounting, statutory and economic capital.

#### **Sources:**

ERM-106-12: Economic Capital-Practical Considerations – Milliman

ERM-108-12: Tiller, Life, health and Annuity Reinsurance, 3<sup>rd</sup> Edition, 2005, Chapter 5, Advanced Methods of Reinsurance

#### **Commentary on Question:**

*The purpose of this question was to test the candidates' knowledge of economic capital concepts, and how economic capital (EC) is impacted by different scenarios and business circumstances (Examples: Reinsurance, market shocks, new business etc.). Many candidates did well demonstrating their knowledge of how Required EC and Excess EC are impacted under the different prescribed situations.*

## 4. Continued

*Some candidates confused statutory capital with economic capital, and correspondingly confused statutory implications with economic implications, particularly in sections (b) and (d). Many candidates did not do as well on the Available EC parts of the question, as this required the candidates to rationalize through the change to both MVA and MVL. Often, only one part of the rationalization was done correctly. It is also noted that many candidates did not understand what market capitalization is.*

### **Solution:**

- (a) Describe the following terms. Include in your description the equations that define these items and how they relate to one another.
- (i) Available Economic Capital (AEC)
  - (ii) Required Economic Capital (REC)
  - (iii) Excess Economic Capital
  - (iv) Market Capitalization

### **Commentary on Question:**

*Part (a) was trying to test the candidates understanding of the definitions of economic capital. Candidates did fairly well with AEC, REC, and Excess EC. The majority of candidates did not provide a proper definition for market capitalization. Overall the scores on part (a) were good.*

### **Response:**

AEC: The excess of assets over liabilities on a realistic/market consistent basis.  
(A-L)

REC: The amount of capital needed to support a business within a certain probability of default.

Excess EC: Represents the amount of capital held over the required amount.  
 $\text{Excess EC} = \text{AEC} - \text{REC}$

Market Capitalization: The total value of the issued shares of a publicly traded company. It is  $\text{AEC} + \text{Economic Franchise Value}$ .

- (b) Your analysis will independently consider the following three potential events:
- (i) A significant increase in interest rates
  - (ii) A significant drop in the stock market
  - (iii) A reduction from VaR 95% to VaR 90%

Explain the probable implications in terms of direction and significance to all four items in part (a) for each of the events. Justify your response and identify any additional assumptions you made in your analysis.

## 4. Continued

### **Commentary on Question:**

*For subpart (i) many candidates stated that “Due to duration matching, assets and liabilities decrease by the same amount.” This was inaccurate because, while the statutory values of assets and liabilities were duration matched, it does not necessarily follow that the economic values of these items were also matched. There were a surprising number of candidates who did not understand the impact of interest rates on existing fixed income assets, and thus incorrectly thought an increase in interest rates increased the market value of fixed-income assets.*

*For subpart (ii), some candidates incorrectly believed the drop in the equity market had an impact on the market value of the liabilities because of the guarantee rate, despite the fact that these liabilities are tied to fixed income investments. Few candidates understood that liability values were stable (with the exception of possible changes in surrenders), and thus REC would remain stable.*

*For subpart (iii), candidates who knew the definitions of the items in part (a) did well on this subpart.*

*Overall the first two subparts of part (b) were poorly done, and the third subpart was well done.*

### **Response:**

- (i) Increase in interest rates: Since assets and liabilities are duration matched on a statutory basis, a change in interest rate will be of a different magnitude on an economic basis.

Fixed income assets decrease in value with an increase in interest rates, so MVA decreases. Assuming that the liability discount rate increases with an increase in rates, the MVL decreases. Assuming that the MVA decreases more than the MVL, AEC decreases.

Since the MVL decreases, the REC also decreases.

Assuming REC decreases more than AEC decreases, then the excess EC increases.

It is unclear how market capitalization is affected by a change in interest rates, if at all. Thus, credit was given for any rational response arguing either a correlation or independence between the equity and interest rate markets.



## 4. Continued

- (ii) Drop in stock market:

Value of equity assets declines, but this is a small proportion of total assets since only statutory surplus is backed by equity. MVA decreases.

MVL is unaffected by change in equity. So AEC decreases and REC remains relatively constant. Excess EC decreases.

Assuming that the company's stock has a positive beta, the market capitalization decreases.

- (iii) AEC is unchanged by the VaR metric.  
REC decreases because  $VaR(90) < VaR(95)$ .  
Excess EC increases as a result of the above.  
Market capitalization is unaffected because the REC metric is assumed to be an internal metric that would not change investor sentiments.

- (c) Explain how the addition of one year of new business to the existing EC model would be expected to impact AEC and REC.

**Commentary on Question:**

*Overall this part of the question was poorly done. Many candidates understood that adding new business would increase REC, but there was a lack of understanding as to how AEC would change.*

**Response:**

MVA is unaffected, as the new business is added after the valuation date. Assuming that the new business is priced profitably, then MVL should decrease, so AEC increases.

New business is likely to increase the risks as liabilities have increased. So REC is likely to increase. The increase in REC may not be dollar for dollar with a calculation performed assuming only the new business cohort, because there may be diversification benefits from new business being combined with existing business.

- (d)
- (i) Compare and contrast coinsurance and YRT reinsurance, including the impact each is expected to have on both statutory reserves and capital.

**Commentary on Question:**

*Many candidates did well on this subpart. Some candidates did not have a firm understanding of YRT reinsurance.*

## 4. Continued

### **Response:**

#### Coinsurance:

In Coinsurance, the insurer pays an initial premium to the reinsurer. The insurer pays 30% of all the block's net cash flows to the reinsurer (possibly adjusted by an allowance) and effectively eliminates 30% of the liability from its book. Assets are also transferred.

In YRT, 30% of Net Amount of Risk is ceded at prescribed premium rates. Unlike coinsurance, assets are not transferred with YRT, so the investment risk is not covered.

They are similar in the sense that the insurer is covered for its mortality risks.

With respect to statutory reserves, YRT does not provide large reserve credits whereas with Coinsurance statutory reserves are reduced 30%.

With respect to capital relief, YRT provides some statutory capital credit, whereas coinsurance would likely have more of an impact as required capital and reserves are further reduced.

- (ii) Explain the probable implications for each of the following, in terms of direction and relative magnitude, of entering into the YRT arrangement.
- I. Available Economic Capital (AEC)
  - II. Required Economic Capital (REC)
  - III. Excess Economic Capital

### **Commentary on Question:**

*Many candidates did not correctly explain the implications to AEC. Very few candidates recognized that YRT is likely priced at a profit to the reinsurer, and thus AEC should decline.*

### **Response:**

The MVA is unchanged, unless the first year reinsurance premium is reflected. Reinsurer likely priced the YRT at a profit, so MVL should increase. Thus AEC decreases slightly.

REC decreases because risk is being transferred to the reinsurer.

Presumably, the YRT should have more of an impact in tail risk scenarios, so the REC should decline more than the AEC, and the Excess EC increases.

## 4. Continued

- (iii) Explain the probable implications for each of the following, in terms of direction and relative magnitude, of entering into the coinsurance arrangement.

- I. Available Economic Capital (AEC)
- II. Required Economic Capital (REC)
- III. Excess Economic Capital

**Commentary on Question:**

*Many candidates did not understand what would happen to AEC. Many assumed it would drop without giving justification.*

**Response:**

MVA decreases because assets are transferred to the reinsurer, but offset by an initial ceding allowance. MVL decreases as liabilities are ceded to the reinsurer, offset by future allowances. This decrease is somewhat offset by the fact that the coinsurance deal is priced at a profit by the reinsurer. Impact on AEC depends on the relative decreases of the MVA and the MVL, so AEC could increase or decrease, but likely not by large amounts.

REC decreases because risk is transferred to the reinsurer.

Since REC decreases and change in AEC is likely not significant, Excess EC probably increases.

- (iv) Describe how you would assess which reinsurance arrangement results in a better EC position for the company.

**Commentary on Question:**

*Many candidates proposed assessing the reinsurance arrangement purely based on the impact on Economic Capital. Very few considered the return aspect of the reinsurance arrangements. Risk and return need to be assessed together, not separately.*

**Response:**

The firm could choose a return on capital metric such as RAROC – the arrangement with the higher return is better. The AEC and REC metrics alone do not do an adequate job of determining the reinsurance arrangement because the return aspect is not considered.

## 5. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

### Learning Outcomes:

- (2a) Demonstrate how each of the financial risks faced by an entity can be amendable to quantitative analysis including an explanation of the advantages and disadvantages of various techniques such as Value at Risk (VaR), stochastic analysis, scenario analysis.
- (2d) Apply and analyze scenario and stress testing in the risk measurement process.
- (2h) Construct approaches to managing various risks and evaluate how an entity makes decisions about techniques to model, measure and aggregate risks including but not limited to stochastic processes.

### Sources:

ERM-602-12: *Investment Management for Insurers*, Babbel and Fabozzi, Chapter 11, The Four Faces of an Interest Model

ERM-106-12: Economic Capital-Practical Considerations – Milliman

### Commentary on Question:

*This question tested candidates' ability to understand and apply various interest rate models. Most candidates did well on comparing/contrasting equilibrium and arbitrage-free models (part (a)) and in identifying the appropriate models for various situations (parts (c) through (e)). Few candidates did well on comparing/contrasting risk neutral and realistic probabilities (part (b)).*

### Solution:

- (a) Compare and contrast arbitrage-free versus equilibrium interest rate models.

### Commentary on Question:

*Most candidates did well on this part.*

### Response:

Arbitrage-free model:

- Takes the current market prices as given and backs into the parameters such that the model fits the current prices
- Does not model the dynamics of the term structure
- Includes time-dependent parameters with at least one parameter for each market price used
- Is basically an interpolation system

## 5. Continued

Equilibrium models:

- Unlike arbitrage-free, these models do model the dynamics of the term structure over time
- They do not match the current market prices
- They utilize a statistical approach
- Do not utilize time-dependent parameters

- (b) Compare and contrast the use of risk neutral probabilities versus realistic probabilities in the parameterization of interest rate models.

### **Commentary on Question:**

*Few candidates did well on this part. Many didn't seem to realize that the risk neutral process requires adjustments to the probabilities and was equivalent to the realistic scenario except it used a risk-free rate. We note that there were two sources in the syllabus that described risk neutral valuation and they took different approaches to adjusting rates or cash flows in risk-neutral valuation (ERM 602-12 and ERM 106-12). Candidates received full credit for describing either approach if it was explained accurately.*

### **Response:**

Risk-neutral:

- Stipulates that no matter how risk averse an investor is, we can identify a set of spot rates that value the bonds correctly relative to the market.
- This is done by changing the probability distribution of the short rate such that the spot rate of every term is equal to the expected return from investing at the short rate over the same term.
- Risk-neutral is used for current pricing. When market prices are reliable they are used in an arbitrage-free setting. When prices are not reliable they would be used with an equilibrium model.

Realistic

- Recognizes that there is normally an upward sloping yield curve, reflecting term premium
- Used in stress testing and asset/liability strategies under adverse movements in interest rates.

- (c) Identify the model classification letter of the derivative team's model and explain how the parameters would be set.

### **Commentary on Question:**

*Most candidates were able to correctly identify the correct model. Many understood that the parameters were set by matching them to the bond and swap prices.*

## 5. Continued

**Response:**

The correct model is A, Risk-Neutral (no term risk premium) and Arbitrage-free (parameters are a function of time).

$u_0$  and  $\theta(t)$  are matched to the bond prices.

$\kappa(t)$  and  $\sigma(t)$  are matched to the swap prices.

- (d) Identify the model classification letter of the model that would be most appropriate for your analysis of interest-sensitive products. Justify your choice.

**Commentary on Question:**

*Most candidates were able to correctly identify the model, but many did not justify their answer sufficiently.*

**Response:**

Model D, equilibrium and with realistic probabilities, is required.

It is important to model the behavior of the term structure over time (equilibrium).

We are just interpolating to get the derivative prices (equilibrium).

It is important to capture the risk premium (realistic) in order to complete a real-world analysis of asset adequacy and VaR calcs.

- (e) Propose a modified form of the Black-Karasinski model to use in your work and explain how the parameters will be set.

**Commentary on Question:**

*Answers were mixed on this section. Some candidates correctly removed the time dependent parameters or included the term premium, but few made both of the changes required.*

**Response:**

$$du = \kappa(\theta - \lambda(u) - u) dt + \sigma dz$$

$u_0$  is statistically fit to bond prices

$\kappa, \theta, \sigma, \lambda(u)$  are historically estimated

## 6. Learning Objectives:

2. The candidate will understand the concepts of risk modeling and be able to evaluate and understand the importance of risk models.

### Learning Outcomes:

- (2g) Analyze and evaluate model and parameter risk.

### Sources:

Financial Enterprise Risk Management, Sweeting, 2011

- Chapter 14, Quantifying Particular Risks, pgs. 311 – 313

ERM-104-12: Study Note on Parameter Risk, Venter and Sahasrabudde

### Commentary on Question:

*This question was focused on the application of parameter risk. Candidates did well on the recall part of this question but struggled to apply the concepts to the Palisades case.*

### Solution:

- (a) Define parameter risk, sampling risk and data bias, and explain how these three items relate to one another.

#### Commentary on Question:

*Most candidates did well on this part of the question, which was primarily recall.*

#### Response:

Parameter risk – uncertainty as to whether the parameters are appropriate for the phenomenon being modeled

Sampling risk – uncertainty that the sample of data upon which our parameter estimate is based differs from the estimate derived based on the entire population

Data bias – uncertainty that is introduced when observed experience is adjusted / needs to be adjusted in order to render it homogeneous and comparable over different periods of time

Sampling risk and data bias are the primary sources of parameter risk

- (b) Explain to Palisades its potential exposure to sampling risk using examples which are specific to its situation.

#### Commentary on Question:

*Since the question asked for examples (plural), two examples were required for full credit. Many candidates only provided one example of sampling risk. Most focused on identifying the use of the 2007-2011 data set to estimate the mean and volatility return parameters as an example of sampling risk.*

## 6. Continued

*To obtain full credit, the answers needed to both identify and explain how the example applied to Palisades specifically. For example, it was not sufficient to say that using 10 funds to estimate fund management fee levels is a source of sampling risk. The candidate needed to explain that using 10 funds may lead to sampling risk as 10 funds constitute a small sample. The smaller the sample size, the greater the likelihood that the sample does not reflect the characteristics of the population. In this case, the fund management fee level for these 10 funds may not adequately represent the overall fee level especially since there is no assurance that these 10 funds represent the bulk of assets managed by Palisades.*

*To be clear, this explanation is required because the use of 10 funds may also lead to data bias if one bases the response on the explanation that these 10 funds are passively managed and the fund management fee levels Palisades wants to estimate relate to actively managed funds.*

### **Response:**

Sampling risk can arise from the estimation of the mean return and volatility parameters, which are estimated using data from 2007-2011. To the extent that this period of time is not representative of the mean returns / volatilities over the period of time for which Palisades is projecting, this may introduce error. The sample period may be unrepresentative of expected future mean returns / volatilities because the period might be too short.

Sampling risk can arise if the 10 mutual funds upon which Palisades estimates the fund management fee are not representative of the population average. Funds are selected based on being common to most accounts which may not represent the majority of assets invested. Therefore, it may provide a poor estimate of the true average fund management fee.

- (c) Explain to Palisades its potential exposure to data bias using examples which are specific to its situation.

### **Commentary on Question:**

*Similar to part (b), two examples were required to receive full credit. Candidates struggled with this part of the question. Most of the examples given were actually sampling risk rather than data bias. Again, certain aspects of the data could be considered an example of data bias or of sampling risk (for example, the use of 10 funds as further explained in (b) above) – to receive credit, the candidate needed to include an explanation that showed an understanding of the difference between the two. The best answers also explained how the example applied to Palisades specifically.*



## 6. Continued

### **Response:**

Data bias can arise from using the calendar years 2007-2011 to estimate mean and volatility, since that period included the financial crisis and thus may not be comparable to other periods unless adjusted.

If different fund types (with different fund management fee levels) were prevalent during different portions of this time period, then the average fund management fee estimate will fail to account for this.

Similarly if the average level of fund management fees has been trending lower because of increased competition or increased prevalence of indexed funds, or trending higher because of increased prevalence of actively managed funds, then the estimation of an average fund management fee will be biased by this trend.

Since the new product only offers protection against declines in specific Palisades mutual funds, the most popular funds may not be representative of the ones allowed in the new product.

- (d) Explain how parameter risk can be either systemic or diversified across a portfolio of risks. Provide examples which are specific to the Palisades context.

### **Commentary on Question:**

*Some candidates were able to provide definitions of systemic risk and diversification but many did not explain how these applied to Palisades. Partial credit was given for definitions only. For full credit for this part, the candidate needed to explain how the concepts applied to Palisades specifically. Some candidates focused on the diversification of adding more data instead of how diversification impacted Palisades' parameter risk.*

### **Response:**

Systemic risk is created when the model's parameters are faulty because the model is biased consistently by the error. For example, if Palisades mis-estimates the volatility parameter, then the Palisades model will systematically over or under price this new product.

A diversification benefit may be created if more than one parameter is mis-estimated or if a particular parameter is misstated for a variety of funds. For example, if Palisades has a number of parameter estimation errors, the resulting errors may be offsetting and thus the risk will be diversified.

- (e) Recommend improvements Palisades could implement to reduce parameter risk, sampling risk and data bias.

## 6. Continued

### **Commentary on Question:**

*Many candidates were able to provide 2 or 3 recommendations for reducing parameter risk, sampling risk, or data bias; in some cases a single recommendation addressed more than one of the risks. The strongest candidates provided recommendations specific to Palisades, linked these directly to the risk that would be reduced and then explained how that risk would be reduced. Weaker candidates only provided a list and did not explain how they applied in Palisades' case specifically or what specific risk they would reduce.*

*Several possible answers are presented below; to get full credit, a candidate needed to address all three risks within the recommendations.*

### **Response:**

#### Parameter risk

- Palisades could back-test the model in various time frames to determine how well the model would have held up in the past.

#### Sampling risk

- Palisades should use a longer time frame of data to establish the mean and volatility estimates. Using a longer period will help to reduce the impacts of extreme market conditions (e.g., the financial crisis).
- Palisades could use more funds to establish the fund management fees and focus specifically on funds which are expected to reflect the characteristics of the funds it intends to model (i.e., select sample from the population of funds being modeled).
- Palisades could use funds that represent the largest portion of its account values rather than the most common funds.

#### Data bias

- Palisades should base its fund management fee assumption on the funds that are included in the protection product.
- Palisades should examine trends in the fund management fees that have occurred over this time period to determine if adjustments need to be made, based on the types of funds that were popular during the prior time period as compared to those that they allow the client to choose from under the new product.
- Palisades should consider using a different period to base its mean and volatility parameters on, given that the 2007-2011 timeframe was subject to the financial crisis. Alternately, Palisades could place weights on the data from this time period to reflect its assessment of the likelihood that such market conditions occur again.

## 7. Learning Objectives:

3. The candidate will understand how the risks faced by an entity can be quantified and the use of metrics to measure risk.
5. The candidate will understand the concept of economic capital, risk measures in economic capital assessment and techniques to allocate the cost of risks within business units.

### Learning Outcomes:

- (3c) Analyze quantitative financial data and construct measures from insurance data using modern statistical methods (including asset prices, credit spreads and defaults, interest rates, incidence, causes and losses). Contrast the available range of methods with respect to scope, coverage and application.
- (5e) Propose techniques for allocating/appropriating the cost of risks/capital/hedge strategy to business units in order to gauge performance (risk adjusted performance measures).

### Sources:

Value-at-Risk, Third Edition, The New Benchmark for Managing Financial Risk, Jorion, 2007

Chapter 19, Operational Risk Management (excluding 19.5)

SOA Monograph – A New Approach to Managing Operation Risk – Chapter 8

<http://www.soa.org/Research/Reasearch-Projects/Risk-Management/research-new-approach.aspx>

### Commentary on Question:

*The question tests the candidates' knowledge of operational risk from inadequate or failed internal processes, people and systems. To receive maximum points, the candidates had to clearly explain risks and provide examples specifically relating to the VA hedging program. Additional question parts tested knowledge of appropriate assessment tools and how they would be applied, modeling of the risks, and plans for addressing the risks. The final section required a calculation of expected losses.*

### Solution:

- (a) Provide two realistic examples of material operational risks relating to the VA hedging operation (other than the risk of unauthorized trading) for each of the three internal sources of operational risk above.

### Commentary on Question:

*Candidates generally did well on this question part. They were able to define operational risks relating to the VA hedging program for each of the sources and provide two realistic examples of each.*

## 7. Continued

### Response:

#### (Examples of risks – other examples also earned credit):

- Process risk
  - Hedge model assumptions relied on data with undiscovered data issues
  - Liability data inputs into the hedging system are late or missing
- People risk
  - Established procedures ignored by employees (willfully or otherwise), causing SOX compliance issues
  - Key staff leaving company without warning, resulting in hedge strategy implementation problems
- Systems risk
  - Trading system fails to work after a software update
  - Computer virus knocks out trading system

(b) You use the following three tools to assess the operational risks identified in part (a):

- Critical self-assessment
- Key risk indicators
- Formal quantification

(i) Describe each of these three assessment tools.

(ii) Choose one of your examples from **each** of the three internal sources of operational risk and select the most appropriate assessment tool for the chosen example. Justify your response.

### Commentary on Question:

*Most candidates were able to do sub-part (i) of the question although some candidates confused some tools as being objective vs. subjective and otherwise. For those who completed sub-part (i), most were then able to successfully match the tools to their examples from part (a) and were able to justify their responses.*

### Response:

(i)

- Critical self-assessment is employed when each department submits **subjective** evaluation of sources of operational risk
- Key risk indicators is employed when a centralized unit produces **subjective** risk forecasts using risk indicators

## 7. Continued

- Formal quantification is employed when a distribution of operational risk losses is **objectively** measured from a database
- (ii)
- Process risk example: liability data inputs into the hedging system are late or missing. The most appropriate assessment tool would be formal quantification since the number of occurrences of missing data could be captured from the hedging system and used to populate an operational risk database.
  - People risk example: established procedures ignored by employees (willfully or otherwise). The most appropriate assessment tool would be critical self-assessment since department management is in the best position to monitor what employees are doing.
  - System risk example: trading system fails to work after a software update. The most appropriate assessment tool would be key risk indicators. Many companies employ business continuity procedures and have estimates of lost productivity, as well as direct costs, resulting from systems failure. They could track historical occurrences of such system failures centrally to produce key risk indicators.
- (c) You are working to determine the appropriate models to use to estimate the frequency and severity distributions associated with the risk of unauthorized trading.

Describe how you would use internal and / or external data to specify the model for assessing the risk of unauthorized trading.

### **Commentary on Question:**

*Many candidates struggled with this question, particularly in trying to identify whether internal or external data would be best for the unauthorized trading model.*

### **Response:**

- Case for internal data
  - Operational losses include many small errors with low costs (high-frequency/low-value); if majority of losses were this type, internal data is appropriate
  - External data might be incomplete (reporting bias)
  - External data might not be directly applicable for a given exposure
- Case for external data
  - For operational losses that are low-frequency/high-value, internal data may not exist or is insufficient
  - Public (external) data tend to be well documented

## 7. Continued

- Greater volume without necessarily sacrificing applicability (e.g. consortium data)
  - Using **external** data is likely best for unauthorized trading model because the key exposure to the risk of unauthorized trading is the low-frequency/high-value events, for which internal data may not exist or is insufficient.
- (d) Regarding the risk of unauthorized trading:
- (i) Describe a realistic corrective Loss Reduction action or plan. Explain your response.
  - (ii) Describe a realistic corrective Loss Prevention action or plan. Explain your response.

### **Commentary on Question:**

*Candidates did generally well on this question part; they were able to distinguish between realistic loss reduction vs. loss prevention plans.*

### **Response:**

- Loss reduction action or plan is a plan which mitigates the **cost** (i.e., **severity**) of unauthorized trading. Examples needed to be realistic, appropriate and corrective. An example would be setting stringent trading limits, above which supervisor authority is required.
  - Loss prevention action or plan is a plan which decreases the **frequency** of unauthorized trading. Examples needed to be realistic, appropriate and corrective. An example would be enhancing the audit function or using a third party specialist firm to execute trades.
- (e)
- (i) Calculate the expected loss from this risk over a one year period.
  - (ii) Calculate the 99.9<sup>th</sup> percentile unexpected loss for this risk over a one year period.

### **Commentary on Question:**

*Most candidates were able to calculate sub-part (i) correctly. Some candidates were able to also calculate sub-part (ii) correctly, but the majority had some difficulty with it.*

## 7. Continued

### Response:

- The expected loss calculation:
  - $E[L] = E[F] \times E[X]$  (expected frequency times expected severity)
  - $(0 \cdot 0.7 + 1 \cdot 0.2 + 2 \cdot 0.1) \cdot (1 \cdot 0.5 + 5 \cdot 0.4 + 20 \cdot 0.1)$
  - \$1.8m
- The 99.9th-percentile unexpected (or the 99.9th percentile VaR) is the same as the worst possible loss calculation:
  - $\Pr(\text{Frequency} = 2) \cdot \Pr(\text{first loss} = 20) \cdot \Pr(\text{second loss} = 20) = 0.1 \cdot 0.1 \cdot 0.1 = 0.001$
  - The 99.9th percentile total loss = \$40M
  - Therefore, the 99.9th percentile unexpected loss =  $40 - 1.8 = \$38.2\text{m}$

## 8. Learning Objectives:

4. The candidate will understand the approaches for managing risks and how an entity makes decisions about appropriate techniques.

### Learning Outcomes:

- (4a) Evaluate the rationale for managing risk and demonstrate the selection of the appropriate risk retention level and hedging of risk.
- (4j) Analyze the application of Asset Liability Management and Liability Driven Investment principles to Investment Policy and Asset Allocation/

### Sources:

AAA Monograph, Fair Valuation of Insurance Liabilities: Principles and Methods  
[http://www.actuary.org/pdf/finreport/fairval\\_sept02.pdf](http://www.actuary.org/pdf/finreport/fairval_sept02.pdf)

ERM-401-12: Mapping of Life Insurance Risks

### Commentary on Question:

*The question tested candidates on their knowledge of fair value considerations and their skills in analyzing the case study situation and applying their fair value knowledge to the company's products. Candidates who did well on the question were able to communicate their knowledge and comprehension in their responses*

### Solution:

- (a) Describe how each of the following types of risks are manifested within the SPIA LOB for SLIC:
  - (i) Market risk
  - (ii) Insurance risk
  - (iii) Operational risk
  - (iv) Liquidity risk

### Commentary on Question:

*Candidates needed to demonstrate good understanding of what these risks mean and specifically how these risks apply to SLIC's SPIA business. There was minimal credit given for generic descriptions of the risks.*

*There were a handful of candidates who seemed to be able to allocate their time and effort into this portion of the question adequately and provide in-depth responses. The majority did not answer this part as well as expected, gave insufficient responses for each risk or provided answers that were too general or only partially true.*



## 8. Continued

### Response:

#### (i) **Market Risk – includes interest rate risk, reinvestment risk, etc:**

- Interest rate risk for SLIC's SPIA product
  - Interest rates have fallen
    - i. For new business, investment into lower yielding fixed income assets to support reserves and capital makes it difficult to meet historical pricing targets.
    - ii. For existing business, reinvestment risk comes about from the inability to replace the existing higher yielding assets as they mature.
  - If interest rates increase, the existing fixed income portfolio will decrease in value.

#### (ii) **Insurance Risk:**

- Longevity risk for SLIC's SPIA:
  - Recent mortality improvement seems to be higher than expected. This can result in unexpected product losses as the annuitants outlive their expected lifetimes resulting in higher benefit payments over time.
- Expense or other insurance risks for SLIC's SPIA:
  - Outside of the longevity uncertainty, SPIA's liability cash flow is relatively predictable and therefore low insurance risk.

#### (iii) **Operational Risk:**

- SLIC's operational risks including errors in claims processing, fraud, etc.
  - SLIC does not have an operational risk model. Unexpected losses due to inadequate information systems and ineffective internal control may be significant.
- SLIC's business continuation and other operational risks
  - The CRO is responsible for both collecting and disseminating risk information, which might be prone to errors and misrepresentation without internal control and review.
  - SLIC expects regulatory relief in case of a systemic crisis, which doesn't seem to be an appropriate, ethical risk management assumption.

## 8. Continued

### (iv) Liquidity Risk:

- Description of difficulty or lost value in selling specific SLIC assets backing SPIA line
    - SLIC's current liquidity policy requires only sufficient liquid assets to meet demand for cash in one stress-test scenario where markets continue to operate normally and the liquidity crunch affects only the company. This might not be sufficient when the market faces a systemic crisis that hinders the company from performing normal investment operations.
    - SLIC now has new investments that are less liquid than high quality corporate bonds and treasuries, such as real estate, domestic private equity and emerging markets common equity.
  - Discussion of the liability side
    - Outside of the longevity uncertainty, SPIA cashflows are relatively predictable, thus having lower liquidity risk.
- (b) Describe the factors that go into setting the discount rate for the liability value calculation using the Cost of Capital Approach.

### Commentary on Question:

*Most candidates provided the formula for  $r_L$ , but this was not required as long as candidates discussed all of the factors and how they related to the discount rate.*

*Most candidates were able to recall the formula correctly and received full marks. Partial marks were given for other reasonable answers or for defining some of the components.*

### Response:

$$r_L = r_A - (e \times (r_E / (1-t) - r_A))$$

where:

$r_A$  = return on assets

$r_E$  = return on equity

$e$  = Fair Value of Equity / Fair Value of Liability

$t$  = tax rate

- (c) Explain how the change in investment strategy described in the case study will impact the discount rate used in computing the liability using the Cost of Capital Approach.

### Commentary on Question:

*Most of the candidates did well on this part. In addition to the response below, credit was also given to candidates who explained their reasoning and concluded that the increase in  $r_l$  would be less than the increase in  $r_A$ .*

## 8. Continued

### Response:

- Prior investment strategy was in lower yielding, higher quality assets.
- Return on Assets (i.e.,  $r_A$ ) will now increase after investing into riskier assets (higher yield, lower liquidity).
- Either  $e$  or  $r_E$  should increase due to increased perceived riskiness.
- Likely there would be no net change in  $r_L$

- (d) Explain the Option-Pricing Approach modeling challenges arising from the change in investment strategy.

### Commentary on Question:

*Only three well-explained challenges were needed to receive full marks. Candidates generally did poorly on this part.*

### Response:

- Option-Pricing is a multi-scenario approach. This approach presents the following challenges to modeling SLIC's asset portfolio, given the change in investment strategy
- Real Estate assets need to reflect interest rate path-dependent pre-payment risk.
  - Private equity has higher volatility than S&P 500, but it's difficult to establish a relationship.
  - International equity should provide some diversification benefits (i.e., lower beta), and it's difficult to establish relationship between this class and S&P 500.
  - Even though new invested assets have higher liquidity risk, it's difficult to model path-dependent liquidity risks.
  - Target ultimate portfolio and reinvestment assumptions for positive cash flows will need to be established.

- (e) Describe how you would reflect insurance risk in your estimation of the SPIA liability fair value using the Option-Pricing Approach.

### Commentary on Question:

*Several possible responses are shown here. Candidates only needed to give one method, if described well, to receive full credit. More credit was given to answers related to mortality-related modeling and technique than to expense-related factors or other estimates.*

*Most candidates who provided answers did quite well. However, there were also a few candidates who left this part blank.*

## 8. Continued

### Response:

Longevity Risk:

- Could use conservative mortality assumption (i.e., lower mortality than expected) to approximate the impact of insurance risk.
- Could use stochastic-on-stochastic projection to model the risk.
- Could add some kind of factor margin to the final best estimate calculation.
- Could add and sensitize mortality improvement assumption.

Maintenance Expenses

- Could add inflation assumption.
- Could add margin to best estimate expense assumption.

- (f) SLIC's Chief Actuary asks why you have not included the company's own credit risk in your estimation of the fair value of the liability, since asset values clearly reflect this risk.

Provide at least two reasons why your assessment does not reflect SLIC's (or Lyon's) credit risk.

### Commentary on Question:

*Several responses are shown below; only two well-explained reasons were needed for full credit.*

*Candidates' responses varied from strong to weak for this question part. About half of the candidates could provide two reasons and received high marks. The other half of the candidates scored low on this part.*

### Response:

- Reflecting the company's own credit risk gives a counterintuitive BS implication: Liability goes down when rating goes down.
- Reflecting the company's own credit risk gives a counterintuitive IS implication: Earnings go up when rating goes down.
- Insurers can't simply exit contracts (i.e. illiquid liability). Liability is not traded.
- Guarantee funds and existence of co-guarantors mitigate credit risk.
- Users of financial statements don't want company credit risk reflected; if block is purchased, the value would be changed to the credit rating of purchaser.